VZCZCXRO1989
OO RUEHBI RUEHCI
DE RUEHLM #0902/01 2660348
ZNR UUUUU ZZH
O 230348Z SEP 09
FM AMEMBASSY COLOMBO
TO RUEHC/SECSTATE WASHDC IMMEDIATE 0552
INFO RUEHIL/AMEMBASSY ISLAMABAD PRIORITY 8945
RUEHKT/AMEMBASSY KATHMANDU PRIORITY 7183
RUEHNE/AMEMBASSY NEW DELHI PRIORITY 3322
RUEHCG/AMCONSUL CHENNAI PRIORITY 9510
RUEHKP/AMCONSUL KARACHI PRIORITY 2525
RUEHCI/AMCONSUL KOLKATA PRIORITY 0417
RUEHBI/AMCONSUL MUMBAI PRIORITY 6811
RUEATRS/DEPT OF TREASURY WASHDC PRIORITY
RUCPDOC/DEPT OF COMMERCE WASHDC PRIORITY

UNCLAS SECTION 01 OF 03 COLOMBO 000902

SENSITIVE
SIPDIS

DEPARTMENT FOR EEB JENNIFER PETERSON AND TANYA SPENCER
DEPARTMENT PLEASE PASS TO DEPARTMENT OF TREASURY MALACHY
NUGENT/ATTICUS WELLER
DEPARTMENT PLEASE PASS TO USTR MICHAEL DELANEY/VICTORIA
KADER

E.O. 12958: N/A
TAGS: ECON EFIN ELAB PGOV
SUBJECT: MALDIVES STILL FACES SERIOUS ECONOMIC CHALLENGES
WITH AN IMF AGREEMENT

REF: COLOMBO 805

¶1. (SBU) Summary. Although the Government of the Maldives (GOM) has reached a staff level agreement for an IMF loan package, the GOM still faces serious fiscal and balance of payments issues in the near term. President Nasheed, who has been in office for under a year, appears to be in complete accord with standard IMF medicine. The Nasheed administration already had extremely ambitious plans to drastically downsize the civil service, privatize state owned enterprises, and reform taxes. Several private sector contacts reported that the government sets great goals but there is little implementation to meet these targets. The GOM has fixed its exchange rate to the U.S. dollar, resulting in an overvalued local currency, exacerbating the balance of payments problem. Finally, the GOM requests USG technical assistance on areas such as designing privatization programs, selling government bonds, and implementing direct taxes. Post endorses these requests. End Summary.

Political Background: A New Government Faces Stiff Challenges

¶2. (SBU) President Nasheed came into office in November 2008 after former President Gayoom had ruled the Maldives for 30 years. Outside contacts agree that President Nasheed and his cabinet are generally well educated and sincerely believe in their ambitious reforms. Minister of Economic Development Mohamed Rasheed told econoff that the GOM plans to reduce the government civil service (currently the Maldives largest employer) from 33,000 to 18,000 employees. In addition, Minister of Finance and the Treasury Ali Hashim proudly stated that the GOM wants to get out of the business of the private sector by privatizing all state owned enterprises, including the airport, electricity, water and others. These proposed reforms are currently before the Parliament. The government has passed a new labor law regulating hours, workplace safety and permitting unions, which never existed before.

¶3. (SBU) President Nasheed faces a difficult domestic political environment. After 30 years of autocratic rule, the Maldivian institutions are weak and politicized. Despite raising government salaries prior to the May 2009 Parliamentary elections (see reftel), the opposition party

led by former President Gayoom won the most seats, and the opposition now controls the Parliament. A third country diplomat noted that aside from a few appointments, President Nasheed has not been able to pass any bills through the new Parliament.

Serious Economic Situation Remains

¶4. (SBU) The Maldives still has a serious balance of payments crisis, as described in reftel, with less than one month foreign exchange of import cover. According to the Maldives Monetary Authority (MMA) the GOM holds $43 million USD in foreign exchange reserves, which has declined recently. The government budget deficit continues to rise, as government expenditures have increased 25% in 2009, while government revenue has fallen 22%. The GOM is financing 70% of the deficit through domestic financing, primarily monetization as the MMA provides money to GOM. The government external debt will increase to 45% of GDP by the end of 2009, and debt payments have grown from 5% of Maldivian exports of goods and services in 2007 to a projected 10% in 2009. The MMA projects that the government deficit for 2009 will fall to 7% of GDP in 2009, despite a projected 21% drop in revenue, and 16% growth in expenditures, since the government is counting on substantial income from the privatization of state owned enterprises.

¶5. (U) The Maldives sources of foreign exchange are also coming up short. In the critical tourism sector, tourist arrivals fell by 10% in the first six months of the year

compared to 2008, although the decline appears to be slowing. MMA experts thought that tourist spending has declined further, since the resorts attracted tourists with special discount packages. The second most important industry is fishing, but the fish catch is down, apparently due to climate changes, as revenue from fish exports has fallen by 45% in 2009. The Maldives has at least 70,000 expatriate workers, so there are net remittance outflows of $10 million per year, further draining scarce foreign exchange.

Strong Medicine from the IMF

¶6. (SBU) The Maldives has reached a staff level agreement for $60 million, which could rise to as much as $78 million. Note. Despite press reports that the IMF assistance package could reach $100 million, MMA officials report that the IMF said that only $78 million could be provided at most. End Note. The IMF program is for 30 months, although it could be extended. The IMF board will vote whether to approve the Maldives assistance package in late October, and approval is expected.

¶7. (SBU) The IMF staff agreement imposes very strict medicine. The IMF targets include: 1) the MMA must immediately stop monetizing the government deficit by providing money directly to the government, and the government must finance its deficit on commercial terms. The GOM plans to sell government bonds to close the deficit for September; 2) the government must privatize state owned enterprises such as the airport, and utilities such as electricity and water; 3) the GOM should reduce the government civil service by 5,000 employees; 4) the GOM must approve a banking act by December 2010. The government owns 75% of the Bank of the Maldives, and there are also five foreign banks present in the Maldives. The level of non-performing loans has increased from an average of 2% in 2007 to 20% for the Bank of the Maldives and a 7% average for the other banks; and 5) amend the law governing the MMA to provide more independence for the MMA.

Achieving the IMF Targets Will Be Very Difficult

¶8. (SBU) The most pressing challenge for the GOM is

financing government operations for September, since they can no longer borrow from the MMA. Minister of Finance and the Treasury Hashim told Econoff that he has an approximate $8 million budget gap for September. The Bank of the Maldives may fill the immediate gap by purchasing government bonds on "commercial terms". Minister Hashim has stopped GOM capital spending and has sought large reductions in government salaries and benefits. Minister Hashim stated that if he could make it through September he would be ok. In the medium term, the GOM plans to increase the tourist tax from $15 to $45 per head (this is called a "green tax:" and 80% of the revenue is for environmental programs), and initiating a business profits tax and a value added tax, all by 2010.

¶9. (SBU) The second greatest challenge is implementing privatization of state owned enterprises (SOE). Last year the government offered to privatize the airport, but there were no bidders. It does appear that the GOM will privatize the telecommunications service, since the international bank HSBC has agreed to act as an underwriter and apparently the GOM has a bidder. However, privatization of the SOEs will be difficult, both because the government has little or no experience in these complex financial transactions, and the global financial crisis has greatly reduced the available capital for investment.

¶10. (SBU) The head of the local chamber of Commerce and several government officials also worry that new taxes will impose substantial new costs, harming the private sector. The GOM,s new labor law has increased employers wage costs by more than 20%, since the law now regulates hours and requires overtime for work in excess of 48 hours per week. In addition, the government has passed a new pension program

to move from a defined benefit plan to a defined contribution. The pension plan increases taxes by 14% of the employee,s salary (7% paid by the employee and 7% by the employer (both the government and the private sector).

¶11. (SBU) Our private sector contacts strongly support the overall goals of the government, but they see grave deficiencies in planning and implementation. For example, the government provided large wage increases to government employees before the Parliamentary elections but never bothered to determine the total cost. Similarly, the government wants to substantially reduce government salaries and benefits, but a GOM official noted that under the new labor law the government could violate labor contracts by unilaterally reducing government wages and benefits. The new labor law also provides the right to strike, which could create problems if the government substantially retrenches its work force or privatizes the SOEs. Finally, a private sector contact noted that despite all the talk of retrenching the public service, the number of public employees has actually grown.

An Underlying Problem: The Fixed Exchange Rate

¶12. (SBU) The GOM has fixed its exchange rate to the U.S. dollar ($1/12.8 Rufiyaa) since 2001, and the currency appears to be substantially overvalued. Although the GOM has little trade with the U.S., the GOM chose to peg its currency to the dollar because international commodities such as oil are priced in dollars and their European tourists understand prices in fixed dollar terms. The MMA thought that the fixed peg had worked well to promote tourism, and they were loath to change it, although they understand that it was a factor in deteriorating foreign exchange reserves. In addition, the GOM foreign debt is denominated in dollars, so if the GOM devalued its currency it would substantially increase its foreign debt in rufiyaa terms.

Many Requests for USG Government Assistance

¶13. (SBU) The GOM ministries requested USG technical

assistance in virtually all of their meetings with econoff. The most critical needs appear to be help implementing privatization of SOEs, the sale of government bonds, and increasing tax revenue through new taxes. Government officials, particularly lower down in the bureaucracy, have little expertise in these areas.

¶14. (SBU) Comment. The GOM is facing enormous challenges with a new democracy, weak institutions, opposition control of the Parliament, downturns in their primary tourism and fishing industries, and the difficulty in attracting investment capital to privatize SOEs. Although a number of these problems were created by the GOM, Post believes that USG technical assistance could be very helpful for the GOM as they attempt these ambitious reforms. The GOM is trying to do the right thing, but right now they do not appear to have the necessary technical abilities to pull it off. End Comment.

BUTENIS